Financial Tsunami: The End of the World as We Knew It

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*The US Congress' passage of a slightly modified form of the Bush Administration's financial bailout plan on the week of October 3 has opened up the specter for the first time of a 1931-style domino wave of worldwide bank failures. That process is already underway across the US banking sector with the failure, nationalization or forced liquidation in the past weeks of Fannie Mae and Freddie Mac, of the giant Washington Mutual mortgage lender, and the rapid collapse of the nation's fourth largest deposit bank, Wachovia. That was on top of a wave of smaller bank failures that began with IndyMac in the spring**.***

The new act has been described as the financial equivalent of the US Patriot Act, the law that gave the Bush Administration powers in violation of Constitutional safeguards under the climate of the September 11, 2001 attacks.

The treasury will have almost unlimited discretionary powers to price and buy distressed mortgage securities, or any other type of securities – including even car loans and student loans – which it considers important. Treasury can buy from any institution of its choice, through a process of its own design, which is as yet unknown and at a pace which the treasury deems appropriate. Moreover, the Paulson Treasury will 'outsource' most of the management of the $700 billion purchases to the very financial institutions responsible for creating the crisis.

The treasury is reportedly planning to use up to 10 private asset managers to manage the assets purchased under the plan. Big players like PIMCO, Black Rock and Legg Mason are reported likely to be chosen for what will be some of the world's biggest asset management accounts. Heavy private sector involvement from the same community of investment bankers who are perceived to be the villains in this crisis, will make political management of the plan all the more difficult.

Former US Treasury Secretary Paul O'Neill in an interview has called the Paulson plan 'crazy.' O'Neill points out as this author and many other economists have, that the new plan does nothing to assure an end to the banking crisis. It merely rewards many of Paulson's friends on Wall Street at US taxpayer expense. Were the moral backbone of the Democratic Congress at all strong, there would be calls for indictment of Paulson and others in the Bush Administration for criminal misconduct in the most brazen financial swindle in the scandal-ridden American finance history.

As the details of the present crisis reveal, there are huge ideological fault lines making for chaos and a potential meltdown of the Laissez Faire financial system. That present system, which was built on the back of Wall Street financial and banking deregulation since 1987 when Alan Greenspan, a devout follower and close friend of radical individualist Ayn Rand, became Wall Street's man at the Federal Reserve for almost 19 years, is over now with the failure of the Henry Paulson $700 billion bailout scheme. Governments worldwide now face no alternative but to begin the painful process of putting the financial genie back in the bottle and re-regulating an out-of-control financial system. The failure of the UK Government and the US Government to address that fundamental issue is behind the present crisis of confidence.

A brief look at history

The Great Depression in Germany in 1931 began with a seemingly minor event—the collapse of a bank in Vienna, Creditanstalt, that May. For readers interested in more on the remarkable parallels between that crisis and that of today, I recommend the treatment in my earlier volume, *Stoljece Rata*.

That Vienna bank collapse in turn was triggered by a political decision in Paris to sabotage an emerging German-Austrian economic cooperation agreement by pulling down the weakest link of the post-Versailles system, the Vienna Creditanstalt. In the process, Paris triggered a series of tragic events that led to the failure of the German banking system over a period of several weeks. The post-1919 Versailles System, much like the post-1999 US Securitization System, was built on a house of cards with no foundation. When one card was removed, the entire international financial edifice crumbled.

Then, in 1931, there was an inept Brüning government in Germany, which believed severe austerity was the only solution, merely feeding unemployment lines to pay the Young Plan German reparations to the new Bank for International Settlements in Basle.

Then, in 1931 George Harrison, a Germano-phobe, was the inexperienced Governor of the powerful New York Federal Reserve. Harrison was a member of the anglophile Skull & Bones, the elite Yale University secret society which also included George H.W. Bush and George W. Bush as initiates. Harrison, who went on to coordinate the secret Manhattan Project on the development of the Atomic bomb under fellow Skull & Bones member, War Secretary Henry Stimson, believed the crisis had started not from abroad but with German bankers trying to make a profit at the expense of others.

Within weeks of rumor and jitters, the New York Bankers Trust, ironically today a part of Deutsche Bank, announced it would be forced to cut the credit line to Deutsche Bank and by July 1931 began to pull its deposits from all big Berlin banks. Harrison insisted the Reichsbank dramatically raise interest rates to stabilize things, only turning bad into worse as a credit crisis across the German economy ensued.

The Bank of England Governor, Montagu Norman, while somewhat more supportive of Luther argued that his friend Hjalmar Schacht was better suited to manage the crisis. On July 13, 1931, a major German bank, Darmstädter-und Nationalbank (Danat) failed. That triggered a general a depositors' run on all German banks. The Brüning government merged the Danat with a weakly capitalized Dresdner Bank, and made large state guarantees in an effort to calm matters. It didn't.

New York Fed governor, Harrison, who was personally convinced it was a 'German' problem, barked orders to Reichsbank chief Hans Luther on how to manage the crisis according to archival accounts. A foreign drain on Reichsbank gold reserves ensued.

The rest is history, the tragic history of the greatest most destructive war of the 20th Century, with all the suffering that ensued. At that time in history, the American banking elite saw itself, despite a stock market crash and Great Depression in America, as standing at the dawn of a new American Century.

The decline of the American Century

Today, in 2008, some 77 years later, a German Finance Minister stands before the Bundestag announcing the end of that American Century. Today the German government encourages a fusion of Dresdner with Commerzbank. Today Deutsche Bank, which some years ago acquired Bankers Trust in New York in a merger wave, appears to be in a stronger position than its American counterparts as Wall Street investment banks, some more than 150 years old as the venerable Lehman Bros., simply vanish in a matter of days. The American financial Superpower crumbles before our eyes.

In March 2008 there were five giant Wall Street investment banks, banks which underwrote Mortgage-Backed Securities (MBS), corporate bonds, corporate stock issues. They were not deposit banks like Citibank or Bank of America; they were known as investment banks—Morgan Stanley, Merrill Lynch, Goldman Sachs, Lehman Brothers, Bear Stearns.

The business of taking deposits and lending by banks had been split during the Great Depression from the business of underwriting and selling stocks and bonds—investment banking—by an act of Congress, the Glass-Steagall Act of 1933. The law was passed amid the collapse of the banking system in the United States following the bursting of the Wall Street stock market bubble in October 1929.

That Glass-Steagall act was a prudent attempt by Congress to end the uncontrolled speculative excesses of the Roaring Twenties by New York finance. It established the Federal Deposit Insurance Corporation to guarantee personal bank deposits to a fixed sum that restored consumer confidence and ended the panic runs on bank deposits.

In November 1999, after millions spent lobbying Congress, the New York banks and Wall Street investment banks and insurance companies won a staggering victory. The US Congress voted to repeal that 1933 Glass-Steagall Act. President Bill Clinton proudly signed the repeal act with Sandford Weill, the chairman of Citigroup.

The man whose name is on that repeal bill was Texas Senator Phil Gramm, a devout advocate of ideological free market finance, finance free from any Government fetters. The major US banks had been seeking the repeal of Glass-Steagall since the 1980s. In 1987 the Congressional Research Service prepared a report which argued the case for preserving Glass-Steagall. The new Federal Reserve chairman, Alan Greenspan, just fresh from J.P. Morgan bank on Wall Street, in one of his first speeches to Congress in 1987 argued for repeal of Glass-Steagall.

The repeal allowed commercial banks such as Citigroup, then the largest US bank, to underwrite and trade new financial instruments such as Mortgage-Backed Securities (MBS) and Collateralized Debt Obligations (CDOs) and establish so-called structured investment vehicles, or SIVs, that bought those securities. Repeal of Glass-Steagall after 1999, in short, enabled the Securitization revolution so openly praised by Greenspan as the "revolution in finance." That revolution is today devouring its young.

That securitization process is at the heart of the present Financial Tsunami that is destroying the American credit structure. Citigroup played a major part in the repeal of Glass–Steagall in 1999. Citicorp had merged with Travelers Insurance company the year before, using a loophole in Glass-Steagall that allowed for temporary exemption. Alan Greenspan gave his personal blessing to the Citibank merger.

Phil Gramm, the original sponsor of the Glass-Steagall repeal bill that bears his name, went on to become the chief economic adviser to John McCain. Gramm also went on to become Vice Chairman of a sizeable Swiss bank, UBS Investment Bank, in the USA, a bank which has had no small share of troubles in the current Tsunami crisis.

Gramm as Senator in 2000 was one of five co-sponsors of the Commodity Futures Modernization Act of 2000. A provision of the bill was referred to as the 'Enron loophole' because the it was later applied to Enron to allow them unregulated speculation in energy futures, a key factor in the Enron scandal and collapse. The Commodity Futures Modernization Act, as I described in my earlier piece in May, *Perhaps 60% of Today's Oil Price is Pure Speculation,* allowed investment bank Goldman Sachs (coincidentally the former bank of Treasury Secretary Paulson), to make a literal killing in manipulating oil futures prices up to $147 a barrel this summer.

Paulson's impressive interest conflicts

The actions of Treasury Secretary Paulson since the first outbreak of the Financial Tsunami in August of 2007 have been directed with one apparent guiding aim—to save the obscene gains of his Wall Street and banking cronies. In the process he has taken steps which suggest more than a mild possible conflict of interest. Paulson, who had been chairman of Goldman Sachs from the time of the 1999 Glass-Steagall repeal to his appointment in 2006 as Treasury head, had been one of the most involved Wall Street players in the new securitization revolution of Greenspan.

Under Paulson, according to City of London financial sources familiar with it, Goldman Sachs drove the securitization revolution with an endless rollout of new products. As one London banker put it in an off-record remark to this author, "Paulson's really the guilty one in this securitization mess but no one brings it up because of the extraordinary influence Goldmans seems to have, a bit like the Knights Templar order of old.' Naming Goldman chairman Henry Paulson to head the Government agency now responsible for cleaning up the mess left by Wall Street greed and stupidity was tantamount to putting the wolf in charge of guarding the hen house as some see it.

Paulson showed where his interests lay. He is by law is the chairman of something called the President's Working Group on Financial Markets, the Government's financial crisis management group that also includes Fed Chairman Bernanke, the Securities & Exchange Commission head, and the head of the Commodity Futures Exchange Commission (CFTC). That is the reason Paulson, the ex-Wall Street Goldman Sachs banker, is always the person announcing new emergency decisions since last August.

Two weeks ago, for example, Paulson announced the Government would make an unprecedented $85 billion nationalization rescue of an insurance group, AIG. True AIG is the world's largest insurer and has a huge global involvement in financial markets.

AIG's former Chairman, Hank Greenberg—a close friend of Henry Kissinger, a former Director of the New York Fed, former Vice Chairman of the elite New York Council on Foreign Relations and of David Rockefeller's select Trilateral Commission, Trustee Emeritus of Rockefeller University—was for more than forty years Chairman of AIG. His AIG career ended in March 2005 when AIG's board forced Greenberg to resign from his post as Chairman and CEO under the shadow of criticism and legal action for cooking the books, in a prosecution brought by Eliot Spitzer, then Attorney General of New York State.

In mid September, in between other dramatic failures including Lehman Bros., and the bailout of Fannie Mae and Freddie Mac, Paulson announced that the US Treasury, as agent for the United States Government, was to bailout the troubled AIG with a staggering $85 billion. The announcement came a day after Paulson announced the Government would let the 150-year old investment bank, Lehman Brothers, fail without Government aid. Why AIG and not Lehman?

What has since emerged are details of a meeting at the New York Federal Reserve bank chaired by Paulson, to discuss the risk of letting AIG fail. There was only one active Wall Street banker present at the meeting—Lloyd Blankfein, chairman of Paulson's old firm, Goldman Sachs.

Blankfein later claimed he was present at the fateful meeting not to protect his firm's interests but to 'safeguard the entire financial system.' His claim was put in doubt when it later emerged that Blankfein's Goldman Sachs was AIG's largest trading partner and stood to lose $20 billion in a bankruptcy of AIG.

That is a tiny glimpse into the man who crafted the largest bailout in US or world financial history some days ago.

As respected economist, Nouriel Roubini pointed out, in almost every case of recent banking crises in which emergency action was needed to save the financial system, the most economical (to taxpayers) method was to have the Government, as in Sweden or Finland in the early 1990's, nationalize the troubled banks, take over their management and assets, and inject public capital to recapitalize the banks to allow them to continue doing business, lending to normal clients. In the Swedish case, the Government held the assets, mostly real estate, for several years until the economy again improved at which point they could sell them onto the market and the banks could gradually buy the state ownership shares back into private hands. In the Swedish case the end cost to taxpayers was estimated to have been almost nil. The state never did as Paulson proposed, to buy the toxic waste of the banks, leaving them to get off free from their follies of securitization and speculation abuses.

Paulson's plan, the one essentially rejected on September 29 by the House of Representatives, would have done nothing to recapitalize the troubled banks. That recapitalization could cost an added hundreds of billions on top of the $700 billion toxic waste disposal.

Serious bankers I know who went through the Scandinavian crisis of the 1990's are scratching their head trying to imagine how crass the Paulson TARP scheme is. That politically obvious bailout of Wall Street by the taxpayers, what some refer to as 'Bankers' Socialism—socialize the costs of failure onto the public, and privatize the profits to the bankers—is a major factor behind the defeat of the TARP compromise version. Under Paulson's scheme, which seems likely to get very little alteration by Congress in coming days, the Treasury Secretary, initially Paulson, would have sole discretion, with minimal oversight, to use a $700 billion check book, courtesy of taxpayer generosity, to buy various Asset Backed Securities held not only by Federal Reserve regulated banks like JP Morgan Chase or Citicorp, or Goldman Sachs, but also by hedge funds, by insurance companies and whomever he decides needs a boost.

'The Paulson plan is unworkable,' noted Stephen Lewis, chief economist with the London-based Monument Securities. 'No one has an idea how to set a price on these toxic securities held by the banks, and in the present market a lot of them likely would be marked to zero.' Lewis like many others who have examined the example of the temporary Swedish bank nationalization, called Securum, during their real estate collapse in the early 1990's, stresses that ultimately only a similar solution would be able to resolve the crisis with a minimum of taxpayer cost. 'The US authorities know very well the Swedish model, but it seems in the US nationalization is a dirty word.'

But there is an added element. John McCain decided to boost his flagging Presidential campaign by trying to profile himself as a 'political Maverick' one who opposes the powerful Washington vested interests. He flew into Washington days before the Paulson Plan was to be approved by a panicked Congress and conspired with a handful of influential Republican Senate friends, including Banking Committee ranking member, Senator Shelby, to oppose the Paulson plan. What emerged, with McCain's backing, was a political power play that may well have brought the United States financial system to its knees, and McCain's Presidential hopes with it.

Power and greed are the only visible juice driving the decision-makers in Washington today. Acting in the long-range US national interest seems to have gotten lost in the scramble. As I wrote last November in my Financial Tsunami five part series on the background to today's crisis, all this could be foreseen. It is what happens when elected Governments abandon their public trust or responsibility to a cabal of private financial interests. It will be interesting to see if anyone in Washington realizes that lesson.

Whatever next comes out of Washington, however, one thing is clear, as reflected in what German Finance Minister Peer Steinbrück told the Bundestag. This is the end of the world as we knew it. The American financial Superpower is gone. The only important question will be what and how will the alternative be.

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